

DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 03-0248
Indiana Corporate Income Tax
For the Tax Years 1997 to 2000

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ISSUE

I. Money Received In an Agency Capacity – Gross Income Tax.

Authority: IC 6-2.1-2-2(a)(1); IC 6-2.1-2-2(a)(2); Western Adjustment and Inspection Co. v. Gross Income Tax Division, 142 N.E.2d 630 (Ind. 1957); Policy Management Systems Corp. v. Indiana Department of State Revenue, 720 N.E.2d 20 (Ind. Tax Ct. 1999); Monarch Steel Co. v. State Bd. Of Tax Comm'r, 699 N.E.2d 809 (Ind. Tax Ct. 1998); Trinity Episcopal Church v. State Bd. Of Tax Comm'r, 694 N.E.2d 816 (Ind. Tax. Ct. 1998); Universal Group Limited v. Indiana Department of State Revenue, 642 N.E.2d 553 (Ind. Tax Ct. 1994); Universal Group Ltd. v. Indiana Dept. of Revenue, 609 N.E.2d 48 (Ind. Tax Ct. 1993); 45 IAC 1.1-1-2; 45 IAC 1.1-1-2(b); 45 IAC 1.1-1-2(b)(2); 45 IAC 1.1-6-10.

Taxpayer – on behalf of taxpayer operating company – argues that it is not subject to Indiana gross income tax on money it received while purportedly acting in an agency capacity.

STATEMENT OF FACTS

Taxpayer is an out-of-state company which filed consolidated Indiana tax returns. One particular return included an operating company which was in the business of running an Indiana riverboat casino. The operating company is hereinafter referred to as “taxpayer operating company.” Taxpayer operating company did not own the casino; it managed the day-to-day operations of the Indiana casino on behalf of the casino owner.

The Department of Revenue (Department) conducted an audit review of taxpayer's business records and tax returns. The Department concluded that taxpayer operating company had received money from the casino owner which was subject to gross income tax. Taxpayer disagreed with this conclusion arguing that the money was received from the casino company while taxpayer operating company was acting in an agency capacity and that, as a result, the money was not subject to gross income tax. Taxpayer (on behalf of itself and taxpayer operating company) submitted a protest to that effect. In addition to the agency/gross income tax argument, taxpayer stated that the initial audit inadvertently included a partnership distribution as subject to gross income tax at both the low rate and the high rate. An initial review of the high/low rate

issue determined that the taxpayer was correct on this issue and that the partnership distribution was only subject to gross income tax at the high rate. Because the audit division has conceded this second issue, that portion of the taxpayer's protest will not be further addressed.

An administrative hearing was conducted during which taxpayer further explained the basis for its agency/gross income tax challenge. This Letter of Findings results.

I. Money Received In an Agency Capacity – Gross Income Tax.

Casino owner and taxpayer operating company entered into a "Project Development and Management Agreement" (Agreement) whereby taxpayer operating company arranged for the construction of the casino and agreed to subsequently provide for the day-to-day operation of the casino once construction was completed. Taxpayer operating company assisted in obtaining the casino license, but casino owner was the entity which actually held the casino's license.

Under the terms of the Agreement, taxpayer operating company had the responsibility to recruit and train the casino staff members, create and implement a casino marketing program, obtain the casino license on behalf of the owner, acquire the necessary start-up supplies and equipment, and develop start-up and operating budgets.

Under the terms of the Agreement, the casino owner designated taxpayer operating company as the casino owner's "exclusive agent, to supervise, manage, direct and operate the [casino] during the Terms of this Agreement." Taxpayer operating company was granted "all the prerogatives normally accorded to management in the ordinary course of commerce, including . . . the collection of receivables, the incurring of trade debts, the approval and payment of checks, the advance of credit and the negotiating and signing of operational leases and contracts." In addition, the Agreement stipulated that "Unless this Agreement expressly provides for an item or service to be at [taxpayer operating company's] own expense, all costs and expenses incurred by [taxpayer holding company] . . . in the performance of [taxpayer operating company's] obligations under this Agreement shall be for and on behalf of [casino owner]." The Agreement specifically provides that, "All debts and liabilities incurred to third parties by [taxpayer operating company] on behalf of either the [casino] Owner or the Project are and shall remain the sole obligation of [casino] Owner."

In terms of the casino personnel, taxpayer operating company was granted "sole authority to hire, promote, discharge, and supervise all personnel." With the exception of the casino manager, department managers, credit manager, chief financial officer, all the casino employees were designated as employees of the casino owner. All of the costs related to the casino owner's employees were designated as an "Operating Expense of the Project and reimbursed to [taxpayer operating company] on a current basis."

After the Agreement was signed, casino owner began to pay taxpayer operating company money in the form of "management fees" in addition to money which taxpayer operating company characterized as reimbursement for expenses representing the payments advanced by taxpayer operating company to the casino owner's employees. Taxpayer operating company properly included the "management fees" in the gross income tax base as originally filed. However, what

remains at issue is the amount of money which taxpayer operating company received from casino owner which was used to pay the casino employees. Taxpayer contends that this money is not subject to gross income tax because it was received while it was acting in an agency capacity. According to taxpayer operating company, "it was under the control of the [casino owner]," it did not "have any right, title or interest in the money or property received from the transaction," but that the money "passed through to third parties." In sum, taxpayer operating company "was merely the agent through which the funds passed to the third parties."

Indiana imposes a gross income tax upon the entire gross receipts of a taxpayer who is a resident or domiciliary of Indiana. IC 6-2.1-2-2(a)(1). For the taxpayer who is not a resident or domiciliary of Indiana, the tax is imposed on the gross receipts which are derived from business activities conducted within the state. IC 6-2.1-2-2(a)(2). However, 45 IAC 1.1-6-10 exempts that portion of a taxpayer's income which the taxpayer receives when acting in an agency capacity. 45 IAC 1.1-1-2 defines an "agent" as follows:

(a) "Agent" means a person or entity authorized by another to transact business on its behalf.

(b) A taxpayer will qualify as an agent if it meets both of the following requirements:

(1) The taxpayer must be under the control of another. An agency relationship is not established unless the taxpayer is under the control of another in transacting business on its behalf. The relationship must be intended by both parties and may be established by contract or implied from the conduct of the parties. The representation of one (1) party that it is the agent of another party without the manifestation of consent and control by the alleged principal is insufficient to establish an agency relationship.

(2) The taxpayer must not have any right, title, or interest in the money or property received from the transaction. The income must pass through, actually or substantively, to the principal or a third party, with the taxpayer being merely a conduit through which the funds pass between a third party and the principal.

In summary, when applying the above factors to a particular taxpayer, the critical factor is that of control. Notwithstanding the fact that the taxpayer acting for another has no right, title or interest in the money or property received, the taxpayer is not entitled to deduct that income from his gross receipts unless the taxpayer was acting as a true agent subject to the control of his principal.

The Indiana Tax Court in Policy Management Systems Corp. v. Indiana Department of State Revenue, 720 N.E.2d 20 (Ind. Tax Ct. 1999) and Universal Group Limited v. Indiana Department of State Revenue, 642 N.E.2d 553 (Ind. Tax Ct. 1994) reviewed the relationship between the imposition of the state's gross income tax and agency principles, echoed the regulatory standards set out in 45 IAC 1.1-1-2 and 45 IAC 1.1-6-10, and held that an agency relationship required consent by the principal, acceptance and authority by the agent, and control of the agent by the principal.

The taxpayer has the burden of establishing that the reimbursements received from the building owner were not subject to the state's gross income tax. *See Western Adjustment and Inspection Co. v. Gross Income Tax Division*, 142 N.E.2d 630, 635 (Ind. 1957). When discussing tax exemptions, such as 45 IAC 1.1-6-10, the courts have held that the exemptions are strictly construed against the taxpayer and in favor of taxation. *Monarch Steel Co. v. State Bd. Of Tax Comm'r*, 699 N.E.2d 809, 811 (Ind. Tax Ct. 1998). *Trinity Episcopal Church v. State Bd. Of Tax Comm'r*, 694 N.E.2d 816, 818 (Ind. Tax. Ct. 1998).

Taxpayer is correct in pointing out that there are elements of an agent/principal relationship in the Agreement between itself and the casino owner. Taxpayer is also correct that this money was received from the casino owner to pay the salaries of employees who worked in the casino owner's own gambling facility and that the terms of that Agreement *required* the casino owner to reimburse taxpayer operating company for those expenses.

However, neither the terms of the parties' Agreement nor the parties' business practices indicate that the taxpayer operating company was acting as a "true agent" sufficient to warrant finding that the income was not subject to Indiana's gross income tax. In order for a putative agent to avoid the consequences of the gross income tax, the agent must have no control or authority over the receipts at issue because the receipts must pass unimpeded through to the principal. Any apparent control which the agent exercises over the receipts is illusory because, at all times, the agent is simply acting on behalf of the principal. The agent eludes imposition of the gross income tax because the receipts never belong to the agent and because the principal controls the agent's substantive business activities. *See 45 IAC 1.1-1-2(b)(2)*.

There are two elements which are missing here. First, casino owner does not exercise the degree of authority over taxpayer operating company characteristic of an agent/principal business relationship; instead, taxpayer operating company retains operational control over the means and manner in which the casino is operated. Taxpayer operating company was given a substantial degree of independent authority in arranging for the construction of the casino, in determining how the casino would be operated, and setting up the casino's operating budget. Taxpayer operating company was given complete authority over the hiring and firing of personnel. As set out in the parties' agreement, "[Taxpayer operating company] shall have the sole authority to hire, promote, discharge, and supervise all personnel." Taxpayer operating company was expected to consult with the casino owner in hiring certain key personnel, but taxpayer operating company was given "the sole right to determine whom to hire." Although the terms of the Agreement specify that most of the casino personnel were the casino owner's employees, insofar as the employees were concerned, they worked for taxpayer operating company. Taxpayer operating company hired the employees and fired these employees. Presumably, if one of these employees was late for work, it was taxpayer operating company – and not the casino owner – which decided if that employee's next paycheck should be docked. Presumably if one of these employees exhibited a high standard of performance, it was up to taxpayer operating company – not the casino owner – to determine whether the employee was entitled to a bonus or a promotion. Insofar as the relationship between these parties, taxpayer operating company was more than simply a paymaster handing out paychecks to the casino owner's employees at the end of each month. In terms of the day-to-day operation of the casino, the casino employees worked

for taxpayer operating company and worked under the direct control of the taxpayer operating company.

There are other aspects of this Agreement which demonstrate that casino owner did not have direct control over taxpayer operating company. For example in the matter of casino expenditures and budgets, the Agreement stipulated that taxpayer operating company was “entitled to increase these budgets to cover any expenditures or contingencies that were unanticipated by [taxpayer operating company] at the preparation of these budgets” In addition, taxpayer operating company was authorized to “reallocate all or any portion of any amount budgeted with respect to any one item in any of the budgets to another item budgeted therein.”

In the day-to-day operation of the casino’s gambling business, taxpayer operating company was granted “the absolute discretion and authority to determine operating policies and procedures, standards of operation, credit policies, complimentary policies, win payment arrangements, standards of service and maintenance, food and beverage quality and service, pricing, and other standards affecting the [casino], or the operation thereof, to implement all such policies and procedures, and to perform any act on behalf of [casino owner] which [taxpayer operating company] deems necessary or desirable for the operation and maintenance of the [casino]”

The gambling casino belonged to casino owner and casino owner retained ultimate authority to control the operation of that facility, but the taxpayer operating company retained substantially independent autonomy to run that facility. Although the two parties had a specific and well-defined contractual relationship, this is not the sort of relationship envisaged in the regulation which states that, “The taxpayer must be under the control of another. “An agency relationship is not established unless the taxpayer is under the control of another in transacting business on its behalf.” 45 IAC 1.1-1-2(b). Despite the generalized intention of these two parties, taxpayer operating company is not a “true agent” of the casino owner sufficient to establish that this money was not subject to gross income tax because the casino owner – as principal – did not retain control over the manner in which taxpayer operating company operated the casino business. The parties’ agreement establishes the relationship between taxpayer operating company and the casino owner; it does not permit the casino owner to dictate the manner in which taxpayer holding company fulfills its responsibilities under that agreement.

In addition, a second element is missing. Taxpayer operating company has not established that it was merely acting as a conduit for the money eventually paid over to the casino employees. 45 IAC 1.1-1-2(b)(2), in part, requires that, “The taxpayer must not have any right, title, or interest in the money or property received from the transaction. The income must pass through, actually or substantially, to the principal or a third party, with the taxpayer being merely a conduit through which the funds pass between a third party and the principal.” *Id.* In order to establish that it was acting as a “merely a conduit,” taxpayer operating company must establish that only the employees had a beneficial interest in the money. As the Tax Court stated in Universal Group Ltd. v. Indiana Dept. of Revenue, 609 N.E.2d 48 (Ind. Tax Ct. 1993), “[T]he taxpayer’s beneficial interest in income is central to the receipt of gross income.” *Id.* at 50. Taxpayer operating company had a beneficial interest in seeing that the casino employees it hired, supervised, and directed were paid for the work the employees performed in operating the

casino. Because taxpayer operating company was charged with the responsibility for successfully operating the casino, it had a direct beneficial interest in the money it received from casino owner. Taxpayer operating company was not simply a disinterested paymaster distributing paychecks on behalf of the casino owner. Its own interests were inextricably bound with those of the employees, the casino owner, and the money it received from casino owner.

In order to qualify for the agency status it seeks, taxpayer operating company must demonstrate that the casino owner retained the right to dictate the manner in which taxpayer operating company ran the casino and that taxpayer operating company had no right to or control over the money received from the casino owner. "A taxpayer will qualify as an agent if it meets *both* of the . . . requirements." 45 IAC 1.1-1-2(b) (*Emphasis added*). It is plain that casino owner did not retain the right to control the manner in which taxpayer operating company managed the casino business; furthermore, taxpayer holding company had a beneficial interest in the money received from the casino owner.

FINDING

Taxpayer's protest is respectfully denied.